United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

76-5019

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

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In the Matter of INVESTORS FUNDING CORP. OF NEW YORK, IFC COLLATERAL CORP., et al.,

Debtors,

Docket No. 76-5019

JAYTEE-PENNDEL CO.,

Appellant.

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APPELLANT'S REPLY BRIEF

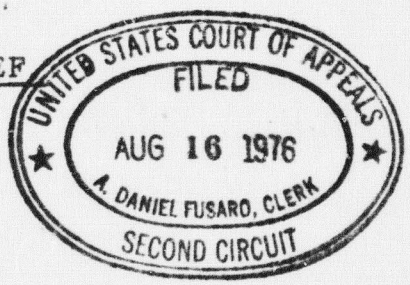

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TABLE OF CASES, STATUTES AND AUTHORITIES

PRELIMINARY STATEMENT

The following brief is intended as a reply to that of the Appellee, which was received by the Appellant on August 2, 1976.

THE "CRITERIA" ISSUE

Notwithstanding the Trustee's characterization of Jaytee's central argument, Jaytee never claimed that a federal district court has no power to enjoin a state court suit against a Reorganization Trustee; instead, Jaytee has pointed out only that (1) there is a presumption against such injunctions and (2) the Trustee must make a substantial showing that the state court action somehow interferes with the Reorganization proceeding.

Diner's Club Inc. v. Bumb, 421 F.2d 396 (9th Cir. 1970), often cited by the Trustee, sets forth those specific criteria upon which such injunctions may be based. Diner's Club Inc. had entered into a contract to purchase 1,500,000 credit cards from a Reorganization trustee, who was carrying on the debtor's business of manufacturing credit cards, and eventually brought suit against the trustee in a state court for breach of contract.[1] Diner's Club appealed the district court's issuance of a permanent injunction restraining any further state proceedings. In reversing the decision of the lower court, the Ninth Circuit held that while the district court had jurisdiction to issue the injunction, it abused its discretion in doing so.

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[1] the state court action alleged $600,000 in damages because of the trustee's negligent employment of a person who was responsible for putting 3,000 false credit cards in circulation.

The Ninth Circuit reaffirmed the long-standing rule that a federal court sitting in Bankruptcy may issue injunctions against state court actions against Reorganization trustees only if it is required (1) to "protect the estate from interference and to ensure its orderly administration" (421 F.2d at 398), (2) to protect the court's "control of a res in its custody" (id.)[2]; or (3) to protect the trustee's operation of the debtor's business from interference (421 F.2d at 400 n.3). In sum, it is to an "interference" criteria to which a district court must look before it can properly issue an injunction against a state court action.

The trustee in Diner's Club had also argued that the state court suit, if successful, might interfere with the projected disbursements under an existing Plan of Reorganization for the debtor corporation by draining the estate of those assets which might be necessary to effectuate the Plan. In dismissing this contention, the Ninth Circuit found on the facts before it that since there was created a special Fund from which the Diner's Club claim could be paid, the Plan could proceed without interference. While the Court left open the question whether or not a particular suit for a substantial amount of money could so "embarrass the administration" of the estate to justify an injunction, it specifically refused to hold that "the pendency of Diner's claim in a substantial and

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[2] Note that the court's power to enjoin is limited only to protect its control of the res, not the economic value of the res itself.

unliquidated amount was a sufficient embarrassment to the administration of the estate to warrant the issuance of an injunction for its trial in the reorganization court." 421 F.2d at 403.

The Trustee in the case at bar did not prove that the pendency of the Rockland County suit itself would interfere with the Reorganization proceeding; indeed, the Trustee never even alleged that this would be the case. It is therefore not surprising that the District Court never made any findings of fact that "interference" was likely to exist, as required by Rule 52 of the Federal Rules of Civil Procedure. In his brief, the Trustee has directed his argument at one of the remedies sought in the state court action by stating as follows: the Rockland County suit, if successful, would lessen the value of the wrap-around mortgage in the hands of the Trustee. In addition to those limited criteria set forth in the Diner's Club case, the Trustee is seeking to have a new criteria established; to wit, that a federal district court may issue an injunction against a state court action if a remedy sought therein, if granted by the state court, would tend to injure the economic interests of the estate. Were the Trustee's new criterion adopted, 28 U.S.C. §959(a) would be rendered meaningless, since it would be hard to conceive of a lawsuit against a Reorganization trustee which would not, if the relief requested therein were granted, tend to injure the estate economically.

It is therefore clear that a District Court must not look to the remedy sought in a state court action against a Reorganization trustee but to the effect the action has on the proceedings in the Bankruptcy court.

THE DISPUTE

The Trustee has oversimplified the substantial issues involved in the Rockland County suit by characterizing it as one based only on the "inadvertent failure"[3] of the Trustee to forward a mortgage payment to the first mortgagee. While this "failure" was an important aspect of the suit, the Rockland County suit alleged that the Trustee further breached its contract by (1) failing to give adequate assurances of performance, (2) failing to render a complete accounting of escrow funds (App. 6), and (3) committing fraud by continually misrepresenting the status of the payment to the first mortgagee.[4] While the Trustee correctly points out that money damages were not sought in the first instance, he fails to mention that the plaintiff could not amend the complaint to demand substantial damages because of the "temporary" restraining order issued by the district court early in the action.

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[3] The Trustee seems to be contradicting the traditional rule that even inadvertent breaches of contract are actionable.

[4] The Trustee or his agents continually assured Jaytee that the November 1974 mortgage payment had been delivered to the first mortgagee notwithstanding the falsity of these statements (App. 5, Supp. App. 39-40). The aspect of the case dealing with fraud was repeatedly argued in the district court(Supp. App. 83, 92).

As to the remedy sought in the Rockland County suit, the Trustee has mischaracterized it as one seeking only to "reform and recast" the wrap-around mortgage; in fact, the plaintiff also sought a declaratory judgment to permit it to make future mortgage payments directly to each mortgagee based on their respective interests in the total indebtedness (App. 8),[5] as well as for other relief.

In addition, Jaytee never questioned the validity of the lien of the wrap-around mortgage in its state court action; consequently, the Rockland County suit cannot be regarded as an action against the property of the debtor, as found in In Re Westec Corp., 460 F.2d 1139 (5th Cir. 1972), where a third party contended that its mortgage had priority over that of the trustee to a parcel of Florida real estate. Notwithstanding its legal arguments to the contrary, the Truste admits on page 25 of its brief that "Jaytee made no claim adverse to the title or property interest of either Collateral or the Trustee. At no time during the proceeding did Jaytee deny that Collateral held a valid wrap-around mortgage. . . ."[6]

The cases cited by the Trustee concern attacks on

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[5] The issue of separate payments was made crucial by the first mortgagee's refusal to accept future mortgage payments from the Trustee. (App. 6, 36).

[6] The Trustee alleges in his brief that "Jaytee's counsel in open court specifically conceeded the approximate amount that was due and owing. (Supp.App. 81-82)" A careful reading of the exchange in court reveals that the discussion concerned the equity interest of IFC in the wrap-around mortgage, not the amount allegedly due and owing for mortgage payments. In fact, there is a misprint on page 82 of the supplemental appendix: "$35,000" should read "$350,000."

property interests of trustees. For example, Field v. Kansas City Refining Co., 9 F.2d 213 (8th Cir. 1925) involved a third party attempt to divest the trustee of its right to maintain railway tracks on the land of the third party; in short, it questioned the title to the property. Likewise, Ex Parte Baldwin, 291 U.S. 610 (1934) dealt with a state suit whose main purpose was to have a "forfeiture declared and the alleged cloud upon title removed." 291 U.S. at 618.

The conceptual problem with the Trustee's argument is that it seeks to pigeonhole the Rockland County suit as one directed at the res rather than tackling the difficult question of whether or not it interfered with the Reorganization proceeding. The mechanical test of determining whether or not a particular suit is directed at the res was specifically rejected in the Diner's Club case

> More important, the burden placed on the reorganization process by a suit cannot be determined simply by inquiry into whether it is directed at the res. Some suits affecting the res will place only slight burdens on the reorganization court. There may be good reasons for permitting them to continue in the state forum. . . . Other suits, even though only money damages are demanded, could conceivably so "embarrass administration" of the debtor corporation . . . as to make it proper that they be stayed. 421 F.2d at 400.

The jurisdictional issue refered to in Point III of the Trustee's brief is also mischaracterized. Cline v. Kaplan,

323 U.S. 97 (1944) involved the question of the Bankruptcy court's jurisdiction to determine the rights vis-a-vis a third party and the Bankruptcy trustee to specific property. The Court's holding that the bankruptcy court had power to adjudicate summarily the rights of third persons to property within its actual or constructive possession is not contradicted by Jaytee's legal position. Likewise, the holding of May v. Henderson, 268 U.S. 111 (1925) that a bankruptcy court has jurisdiction to inquire into the nature of a particular claim[7] does not stand for the proposition that once a court begins to inquire, it obtains jurisdiction for all purposes.

Because there was never a dispute between Jaytee and the Trustee with regard to the validity or respective interests in the wrap-around mortgage, the District Court erred in summarily determining the merits of the underlying Rockland County suit, rather than limiting its decision to the narrow issue before it; to wit, whether or not it should permanently enjoin Jaytee from prosecuting the Rockland County suit.

THE FINAL ORDER

As the Trustee correctly points out, the final order of Judge Bonsal (App. 13-21) was based on the "hearing" held before him on February 17, 1976. Unfortunately for Jaytee, the

[7] ie, whether it is an "adverse claim"(which would require a plenary suit) or whether it is a "voidable preference" (which would be subject to the summary order of the court.

issues determined at the hearing went far beyond those noticed in any paper before the court. Jaytee had no notice that the court proceeding would take the form of an adversary trial, at which money damages of $30,273 and late charges of $2,397 would be sought by the Trustee. Notwithstanding the Trustee's incorrect statement on page 8 of its brief, Jaytee did strenously object to the order and had already submitted a comprehensive brief during the proceedings (Exhibit A).

There is no doubt that a Reorganization court, like any other court sitting in Equity, has broad latitude in designing an equitable remedy to the facts and circumstances of the particular case before it; however, this is not to say that a court can fashion a remedy for a case that is not before it, as framed by the pleadings.

Jaytee has already indicated in its brief that the District Court had no jurisdiction to render a money judgment against Jaytee since the Trustee did not commence a plenary suit against Jaytee (Point II). But even if the court did have subject matter jurisdiction, the only application before it was the Trustee's motion seeking an injunction against a pending state court action. There was no application for a reformation of the wrap-around mortgage (to provide for a mode of separate payments),[8] for a money judgment for back payments, or for a money judgment for late charges and penalties.

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8 While it is true that various alternatives for methods of future payments were discussed in open court, these discussions should be read in the context of "settlement negotiations"- not enlargements of the pleadings.

The imposition of $2,397 of late charges and penalties in the money judgment best illustrates the exacerbation Jaytee suffered in the District Court. Notwithstanding the Trustee's failure to give Jaytee notice that it intended to seek late charges at the February 27th "hearing", notwithstanding Jaytee's continual tender to the Trustee of the net mortgage payment to which he would otherwise be entitled if he would forbear in his application to foreclose the wrap-around mortgage (Supp. App. 50, 56-57, 79-81, 88), the District Court nevertheless imposed substantial penalties on Jaytee.

Jaytee never "contracted" with the Trustee; it had the Trustee thrust upon it by operation of law. Cf. Reading Co. v. Brown, 391 U.S. 471, 478 (1968). Over its objection, the full power and authority of the Federal courts were also thrust upon it because of Jaytee's audacity in trying to protect its legal interests in a state court located in the county of its place of business. The district court below improperly issued a permanent injunction against this legitimate suit and unjustifiably rendered a money judgment against Jaytee containing severe penalties.

The order of the district court should be reversed.

Respectfully,

DENNIS G. KATZ, P.C.
300 N Main St.
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914-356-2525

by _____
Dennis G. Katz

AFFIRMATION OF SERVICE

STATE OF NEW YORK
COUNTY OF ROCKLAND SS:

Dennis G. Katz, an attorney duly admitted to practice before the courts of the state of New York and the U.S. Court of Appeals, Second Circuit, hereby affirms that on the 13 day of August 1976 I served a copy of the within Appellant's Reply Brief upon Weil, Gothsal & Manges, Esqs., attorneys for the appellee, at their office at 767 Fifth Ave., New York, New York 10022 (the address designated by said attorneys) by depositing two copies of the same enclosed in a postpaid properly addressed wrapper in an official depository under the exclusive care and custody of the U.S. Postal Service within the State of New York.

Dennis G. Katz

DULY AFFIRMED THIS
DAY OF AUGUST 1976

DENNIS G. KATZ, P.C.
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March 1, 1976

Hon. Dudley B. Bonsal
United States District Judge
U.S. Courthouse (Foley Square)
New York, New York 10007

Re: Jaytee-Penndel v. Bloor

Dear Judge Bonsal:

I have received a notice of settlement which is returnable before you on March 15, 1976.

On August 12, 1975 James Bloor, as trustee, made an application to this court for an order restraining the continuation of a suit brought against him in the Rockland County Supreme Court by my client, Jaytee-Penndel Co.. I was served with an order signed by you requiring that my client appear before your Honor to show cause why the relief should not be granted. Pursuant to that order, I attempted to set forth my client's legal position with respect to the justifiability of its right to continue the state court action; apparently, your Honor does not agree with the legal theories advanced in my brief and oral argument.

The problem with the proposed order submitted by the attorneys for the trustee is that it goes far beyond the relief requested in the original application. While my client was often chided for seeking to reform and recast the mortgage in state court, the attorneys for Mr. Bloor are seeking to accomplish the same result in federal court. The proposed order goes far beyond the legal issues discussed and, I submit, goes far beyond the jurisdiction of a Federal District Judge, who, I believe, has no power to decide the merits of the underlying controversy, especially since my client has never consented to have the merits decided by a federal court.

I have often been criticized for my insistence that some restitution be made to my client for a portion of the enormous legal fees necessitated by the initial breach of contract, the state court action, and the defense against the application for the permanent injunction - a criticism which has persisted ever since the beginning, when legal fees amounted to less than $1,500. I am therefore particularly distressed by

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the inclusion of a "right" of the trustee to apply to this court for damages, including attorney's fees. Furthermore, the $2,247.60 of late charges included in the proposed judgment is an item only recently brought into the case. Unfortunately, the trustee still does not recognize that this entire situation was occasioned by his breach of contract ("inadvertent" as it may have been) and not my client's decision to seek relief for his breach of contract in the state courts (which he had a prima facie right to do).

I must protest the proposed order.

Respectfully,

Dennis G. Katz

DGK/smu

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